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SUBJECT: ECONOMIC UNCERTAINTY DOGS HONDURAS

¶1. (SBU) Summary: Uncertainty at home and abroad dogged the Honduran economy throughout 2009. With two-thirds of its exports destined for the U.S., the country was hard hit by the U.S. recession. On top of the crumbling international situation, President Jose Manual "Mel" Zelaya created a climate of uncertainty through erratic and populist policy decisions. The June 28 coup d'etat that removed him from power and the ensuing political turbulence led to a cutoff of foreign lending and assistance and has brought foreign and domestic investment to a virtual halt. It will be up to the government of Porforio "Pepe" Lobo to try to rebuild ties with international donors and lenders and restore the confidence of investors. End Summary.

#### The Beginning - Foreign Trade Takes a Hit

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¶2. (U) As a result of the global economic downturn, trade between the U.S. and Honduras declined dramatically beginning in late 2008. This was due at least in part to steep price declines, particularly in commodities such as oil. 2009 trade will fall to levels not seen since 2005. On the positive side for Honduras, the country's trade deficit with the U.S. was reduced to almost zero. Agricultural producers got a double whammy as both prices and volumes declined (although somewhat less in non-traditional exports). Through September, Honduran exports to the U.S. were down 22.1 percent, while exports to Central America as a whole were down only 13.1 percent.

#### The Recession Takes Hold - Construction and Manufacturing

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¶3. (U) By September, according to the official index of economic activity, construction and manufacturing were down 34.7 percent and 8.4 percent, respectively. The construction industry had taken advantage of a mini-real estate bubble in 2006 and 2007 as it outpaced the rest of the economy only to show the greatest decrease when confidence collapsed in 2009. (Anecdotal, since the election there appears to be a new burst of construction activity, although it will take several months for the data to confirm this trend.) Manufacturing took it in the nose as declining international demand socked the maquila industries while falling construction reduced demand for cement and building products.

#### Creating Chaos

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¶4. (U) Rather than trying to ameliorate a worsening economic picture, the government of President Zelaya actually made things worse through a series of erratic and counterproductive policies that further undermined confidence. At the end of 2008, President Zelaya declared a sixty percent increase in the minimum wage, which was to take effect in a matter of weeks. Not only did this increase unemployment in the private sector (as reported by private sector associations -- there are no statistics available), it widened the fiscal deficit of the government because many government salaries are linked to the minimum wage. The Central Bank tried to force down interest rates and coerced the Ministry of Finance to issue only short term debt, drastically worsening the risk profile of the government debt portfolio.

#### The Coup Piles it On - Or Does It?

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¶5. (SBU) Conventional wisdom would say that adding a coup d'tat to the mounting problems of Honduras would be the coup de grace to the economy. International financial institutions stopped disbursements (although many had been stopped or slowed due to the chaotic situation while Zelaya was in power) and the country was diplomatically isolated.

¶6. (SBU) International reserves sagged in the weeks after the coup but the outflow has abated to a slow leakage, actually turning positive for three straight weeks in December. Although exports are down, there is little discernible difference between pre- and post-coup results. The index of economic activity showed its sharpest declines from December 2008 to February 2009 before bottoming out in May. Since the coup, this leading economic indicator, while not in positive territory, has shown signs of stabilizing and improving.

¶7. (SBU) Foreign Direct Investment (FDI) declined 42.3 percent in the first half of 2009 (the most recent data available) due principally to a very large investment in telecommunications in 2008 that was not repeated in 2009. Most of the FDI in the first half of 2009 was in the form of reinvested profits, which represented 76.6 percent of all FDI compared to 46.7 percent in the same period in 2008 and 40.5 percent for the same period in 2007. Anecdotal evidence indicates that FDI and domestic investment have declined even further since the coup d'tat. However, there is no published data to confirm this.

#### The Situation Facing the Lobo Government

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¶8. (SBU) The incoming administration will be faced with a weak, but not moribund, economy. The financial system was isolated from the international financial crisis because the country had little external private debt and local banks do not tend to invest overseas. The system is relatively well capitalized and able to support new loan growth. (Increasing doubtful loans, now at around 6 percent, are a concern but not out of line given the stage of the economic cycle). Commodity prices have recovered, which, combined with a recuperating U.S. economy should help Honduran exports. After a 2009 decline that the de facto government estimates at about 1.5 percent, consensus opinion estimates that Honduras will grow about 2-3 percent in 2010.

¶9. (SBU) The greatest concern for the incoming Lobo administration is the state of public finances, which were in complete disarray at the time of the coup. The de facto regime, with the help of a strong economic team, has improved transparency and met the most important obligations, but has been unwilling to take the hard decisions to get public finances back under control. (A proposed tax package to generate needed revenue was withdrawn without a fight when objections were raised.) The de facto regime also failed to address the issue of the increasingly non-competitive exchange rate, leaving this somewhat distasteful task to its successors.

¶10. (SBU) Tax revenues in 2009 are expected to close the year at L40.1 billion (USD 2.1 billion), down only 5.5 percent from 2008. If this projection proves accurate, it will be an impressive accomplishment, given the overall state of the economy. As of September, the de facto government was projecting a central government deficit of 4.2 percent for ¶2009. In order to close the budget deficit in 2010, the government is forecasting collections of L46.6 billion (USD 2.5 billion), an increase of over 16 percent. In addition, the Lobo transition team is counting on domestic markets for more government bonds and the return of funding from the international community. Both of these assumptions are optimistic, given the limited capacity of domestic markets to absorb debt and uncertainty over how quickly the international community will resume funding.

¶11. (SBU) The Zelaya administration never submitted a 2009 budget, allowing the misappropriation of a huge amount of funds. After President Zelaya's ouster, the de facto regime slapped together a budget based on the 2008 budget, which helped get spending a bit under control but did not adjust for the waste and pilferage they eventually encountered. The de facto government announced that it was reviewing 7 billion Lempiras (approximately USD 370 million) in unbudgeted claims from government creditors. The 2010 budget does not address the serious imbalances of the previous budgets and will need to be revised by the Lobo team as soon as possible. As with other recent budgets, the vast bulk of costs go to current expenses, especially salaries, which are excessively high. As 2009 ended, private sector discussions over the next year's minimum wage had begun, and the de facto government had pledged to have a new minimum wage negotiated by the end of the year. The Supreme Accounts Tribunal was reviewing a large number of invoices to determine whether they represent actual government commitments. However, the Lobo transition team recognized that it would have to honor most of the previous government's commitments, however questionable, in order to maintain the government's credibility as a borrower.

¶12. (SBU) The de facto regime has had better luck getting debt under control by refinancing and extending most of the short term debt incurred at the end of the Zelaya administration (although not without a lot of arm twisting). Nevertheless, the proposed 2010 budget will require even more domestic debt in addition to longer-term external debt of USD 264 million.

Comment  
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¶13. (SBU) The incoming Lobo administration faces a daunting task. They have a budget that is growing inexorably, with ever mounting current expenses that must be funded by 1) an increase in taxes many times the increase in the underlying economy, 2) mounting domestic debt in a very small market with few investors, and 3) reliance on donor flows and external finance in spite of uncertainty over whether donors will be willing to reengage quickly. The hard decisions that the Lobo administration must make will likely foster street protests, strikes and other resistance tactics. The teachers have already announced that they will be undertaking a series of actions to pressure the new government beginning in January and the union negotiators at the minimum wage talks are (unrealistically) demanding an increase of 55 percent on top of last year's 60 percent increase. With the honeymoon for the new Lobo Administration likely to end before its inauguration, uncertainty will continue to dog Honduras in ¶2010. End Comment.

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